

to cost at least several hundred dollars. As a result, some families will choose to drive rather than fly. Yet driving—even with a car seat—is dramatically more dangerous than flying. As a result, requiring car seats on planes might result in more injuries and deaths to children (and adults), not fewer.

Consider another example in which good intentions led to a bad outcome because the incentives were not fully anticipated. Mexico City is one of the most polluted cities in the world; the foul air trapped over the city by the surrounding mountains and volcanoes has been described by the *New York Times* as “a grayish-yellow pudding of pollutants.”⁶ Beginning around 1990, the government launched a program to fight this pollution, much of which is caused by auto and truck emissions. A new law required that all cars stay off the streets one day a week on a rotating basis (e.g., cars with certain license plate numbers could not be driven on Tuesday). The logic of the plan was straightforward: Fewer cars on the road would lead to less air pollution.

So what really happened? As would be expected, many people did not like the inconvenience of having their driving days limited. They reacted in a way that analysts might have predicted but did not. Families who could afford a second car bought one, or simply kept their old car when buying a new one, so that they would always have one car that could be driven on any given day. This proved to be worse for emissions than no policy at all, since the proportion of old cars on the road went up, and old cars are dirtier than new cars. The net effect of the policy change was to put *more* polluting cars on the road, not fewer. A 1995 study found that overall gas consumption had increased. The policy was later dropped in favor of a mandatory emissions test.⁷

The wonder of the private sector, of course, is that incentives magically align themselves in a way that makes everyone better off. Right? Well, not exactly. From top to bottom, corporate America is a cesspool of competing and misaligned incentives. Have you ever seen some variation of the sign near the cash register at a fast-food restaurant that says, “Your meal is free if you don’t get a receipt. Please see a manager”? Does Burger King have a passionate interest in providing a receipt so that your fam-

ily bookkeeping will be complete? Of course not. Burger King does not want its employees stealing. And the only way employees can steal without getting caught is by performing transactions without recording them on the cash register—selling you a burger and fries without issuing a receipt and then pocketing the cash. This is what economists call a principal-agent problem. The principal (Burger King) employs an agent (the cashier) who has an incentive to do a lot of things that are not necessarily in the best interest of the firm. Burger King can either spend a lot of time and money monitoring its employees for theft, or it can provide an incentive for you to do it for them. That little sign by the cash register is an ingenious management tool.

Principal-agent problems are as much a problem at the top of corporate America as they are at the bottom, in large part because the agents who run America’s large corporations (CEOs and other top executives) are not necessarily the principals who own those companies (the shareholders). I own shares in Starbucks, but I don’t even know the CEO’s name. How can I be sure that he (she?) is acting in my best interest? Indeed, there is ample evidence to suggest that corporate managers are no different from Burger King cashiers—they have some incentives that are not always in the best interest of the firm. They may steal from the cash register figuratively by showering themselves with private jets and country club memberships. Or they may make strategic decisions from which they benefit but shareholders do not. For example, a shocking two-thirds of all corporate mergers do not add value to the merged firms and a third of them leave shareholders worse off. Why would very smart CEOs engage so often in behavior that seems to make little financial sense?

One partial answer, economists have argued, is that CEOs benefit from mergers even when shareholders are left with losses. A CEO draws a lot of attention to himself by engineering a complex corporate transaction. He is left running a bigger company, which is almost always more prestigious, even if the new entity is less profitable than the merged companies were when they were on their own. Big companies have big offices, big salaries, and big airplanes. On the other hand, some mergers and takeovers make perfect strategic sense. As an uninformed share-

holder with a large financial stake in the company, how do I tell the difference? If I don't even know the name of the CEO of Starbucks, how can I be sure that she (he?) is not spending the bulk of her day chasing attractive secretaries around her office? Hell, this is harder than being a manager at Burger King.

One answer that has emerged in recent years is the use of stock options as a management compensation tool. This is the CEO equivalent of the sign near the cash register asking if you received your receipt. Most American CEOs and other important executives now receive a large share of their compensation in the form of stock options. These stock options enable the recipient to purchase the company's stock in the future at some predetermined price, say \$10. If the company is highly profitable and the stock does well, climbing to say \$57, then those stock options are very valuable. (It is good to be able to buy something for \$10 when it is selling on the open market for \$57.) On the other hand, if the company's stock falls to \$7, the options are worthless. There is no point in buying something for \$10 when you can buy it on the open market for \$3 less. The point of this compensation scheme is to align the incentives of the CEO with the interests of the shareholders. If the share price goes up, the CEO gets rich—but the shareholders do well, too. It's not a perfect strategy; wily CEOs can find ways to abuse the options game (just as cashiers can find new ways to steal from the register). But the overall strategy makes sense. Given that I don't know the name of the Starbucks CEO, I do hope that he or she has a large chunk of stock options.

The same strategy works for motivating boards of directors, the individuals elected by shareholders to govern publicly held companies. A study conducted by the consulting firm McKinsey & Company found that something as simple as having a company's directors hold large investments in the company's stock correlates with significantly better company performance.⁸ McKinsey found that companies whose directors owned "meaningful equity stakes" in 1987 performed much better over the subsequent decade than companies whose directors did not. When McKinsey looked separately at companies that had significantly outperformed other firms in their business sector, they found that the

median investment of outside directors at the star firms was five times as large as the stake owned by outside directors at the laggard firms.

One need not be a corporate titan to deal with principal-agent problems. There are plenty of situations in which we must hire someone whose incentives are similar but not identical to our own—and the distinction between "similar" and "identical" can make all the difference. Take real estate agents, a particular breed of scoundrel who purport to have your best interest at stake but may not, regardless of whether you are buying or selling a property. Let's look at the buy side first. The agent graciously shows you lots of houses and eventually you find one that is just right. So far, so good. Now it is time to bargain with the seller over the purchase price, often with your agent as your chief adviser. Yet your real estate agent will be paid a percentage of the eventual purchase price. The more you are willing to pay, the more your agent makes and the less time the whole process will take.

There are problems on the sell side, too, though they are more subtle. The better price you get for your house, the more money your agent will make. That is a good thing. But the incentives are still not perfectly aligned. Suppose you are selling a house in the \$300,000 range. Your agent can list the house for \$280,000 and sell it in about twenty minutes. Or she could list it for \$320,000 and wait for a buyer who really loves the place. The benefit to you of pricing the house high is huge: \$40,000. Your real estate agent may see things differently. Listing high would mean many weeks of showing the house, holding open houses, and baking cookies to make the place smell good. Lots of work, in other words. Assuming a 3 percent commission, your agent can make \$8,400 for doing virtually nothing or \$9,600 for doing many weeks of work. Which would you choose? On the buy side or the sell side, your agent's most powerful incentive is to get a deal done, whether it is at a price favorable to you or not.

Economics teaches us how to get the incentives right. As Gordon Gekko told us in *Wall Street*, greed is good, so make sure that you have it working on your side. Yet Mr. Gekko was not entirely correct. Greed can be